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The Stars Align

The M&A Environment in the U.S. Engineering and Construction Space

Welcome

The last several years have been an exciting time for the Telecom Engineering and Construction ("Telecom E&C") space in the United States. Exploding demand for bandwidth is driving significant investment in communications infrastructure, and these favorable industry dynamics have created increased interest in the space from both strategic acquirers and financial investors. As a result, owners of Telecom E&C companies have a unique opportunity to build value in their businesses. This value can be realized through pursuing one of three basic strategies:

- Capitalizing on favorable industry dynamics to drive organic growth
- Selling a portion of the company to an investor to provide a partial payout to owners and a source of funding for future acquisition-related growth
- Leveraging the favorable M&A environment by selling the company to an acquirer that will purchase 100% of the business

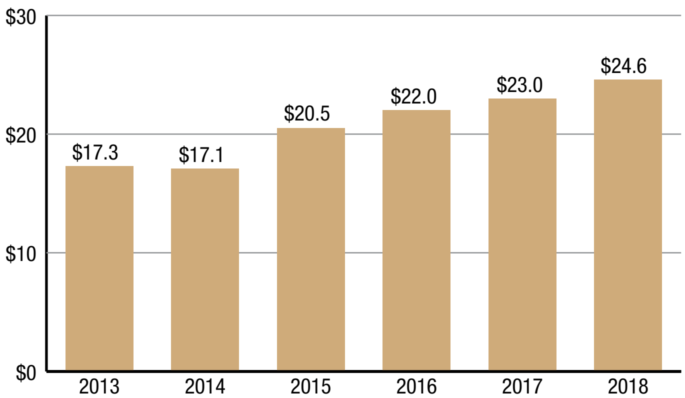
The goal of this report is to provide business owners with a summary of the current market environment in the U.S. Telecom E&C space so they can make an informed choice about how to best capitalize on the current favorable market conditions.

Industry Trends

The U.S. is experiencing a significant increase in spending on communications infrastructure, and this trend is at the heart of the high level of investor interest in the Telecom E&C space. U.S. spending on communications infrastructure in 2018 was approximately $24.6 billion, a 44% increase from the $17.1 billion in spending in 2017[1].

Figure 1: U.S. Communications Infrastructure Spending

$ in Billions



Source: U.S. Census Bureau

Just as importantly, the spending on communications infrastructure shows no signs of letting up. According to a recent report from Deloitte, the U.S. needs between $130 billion and $150 billion in "deep fiber" infrastructure investment over the next five to seven years[2]. This figure is just for fiber infrastructure; it does not include other areas of investment such as the need to upgrade wireless radio access networks to 5G technologies.

The need to invest in more robust fiber optic networks is primarily the result of an exploding demand for bandwidth. According to the Cisco Visual Networking Index (VNI), total North American IP traffic is expected to more than double from 2018 to 2022 as it goes from 52 to 108 Exabytes per month. North American mobile IP traffic is projected to grow at an even faster rate, from 1.8 Exabytes per month in 2018 to 5.9 Exabytes per month in 2022.

The factors underlying these increases are several and include:

- ***Increasing use of higher bandwidth applications.*** Most notably, the increasing demand for IP video drives significant increases in bandwidth usage.
- ***Movement of applications to the cloud.*** As more and more businesses and consumers move to cloud-based applications, networks need to support the traffic that connects these applications to users.
- ***Increasing ubiquity of high-speed wireless connections.*** Individuals are increasingly able to access high-bandwidth wireless connections wherever they happen to be, which allows them to consume increasing amounts of bandwidth. The pending introduction of 5G technologies will only accelerate this trend.
- ***Internet of Things.*** Internet of Things (IoT) investments will increase network traffic as millions of new devices are connected to the Internet. IoT connections in the U.S. are currently growing at a rate in excess of 20%, and are expected to reach more than half a billion by the end of 2025[3].

These favorable macro trends indicate that we are still in the early innings of communications infrastructure spending in the U.S., which in turn provides comfort to investors that there is ample runway to benefit from investments in the U.S. Telecom E&C space.

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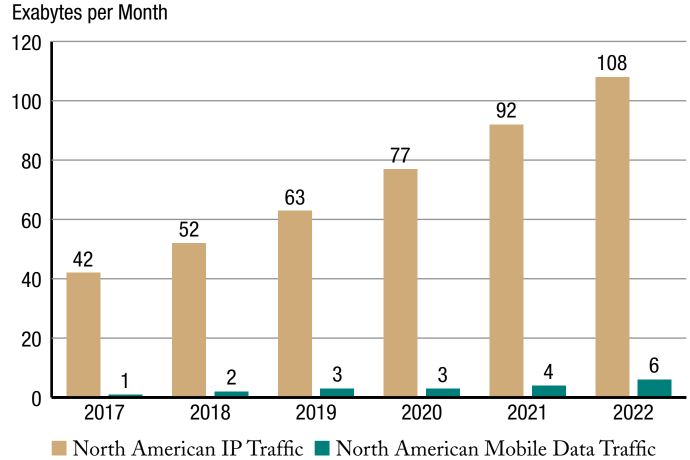
[1] Value of Construction Put in Place in the U.S., U.S. Census Bureau

[2] Communications Infrastructure Upgrade: The Need for Deep Fiber, July 2017, Deloitte

[3] Counterpoint Research, October 2018

Figure 2: Historical and Projected Growth of Data Traffic

Exabytes per Month

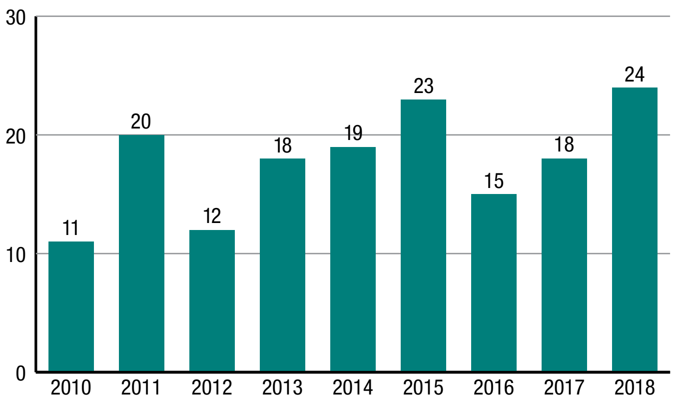


Source: Cisco VNI

M&A Trends

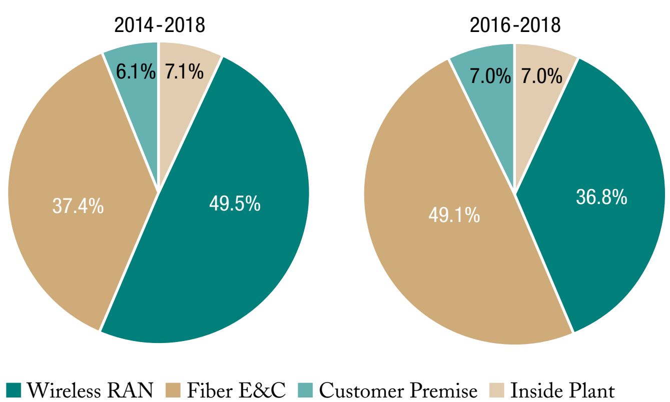
While we have certainly seen ups and downs from year-to-year, M&A activity for Telecom E&C companies in the U.S. has generally trended upward. In fact, with 24 total transactions, 2018 was the strongest year in terms of the number of transactions since we began tracking activity in 2010.

Figure 3: M&A Transactions in the U.S. Telecom E&C Space by Year



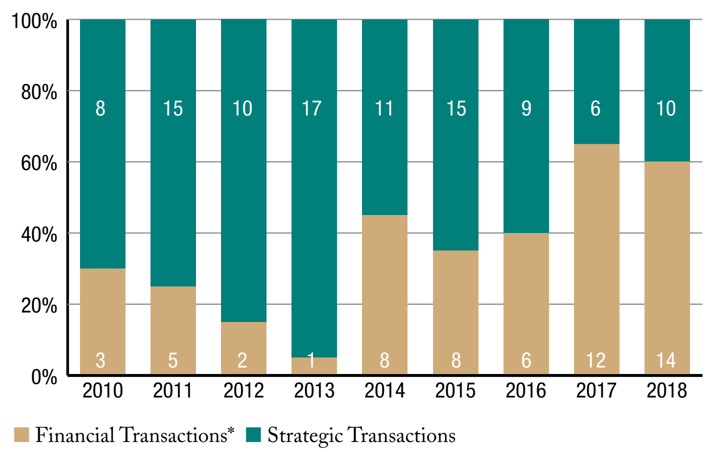
Transactions in the space tend to fall into two primary categories: companies that engineer and construct fiber networks (Fiber E&C) and companies that engineer and construct wireless radio access networks (Wireless RAN). We also see a smaller number of transactions for companies providing either inside plant or customer premise services. Over the last five years, the majority of transactions involved Wireless RAN-focused companies. However, over the last three years the pendulum has swung in the other direction and Fiber E&C companies accounted for the majority of transactions. Either way, industry dynamics are developing in such a way that both areas appear to be poised for significant activity in the next few years.

Figure 4: M&A Transactions in the U.S. Telecom E&C Space by Type



So what are the main drivers behind the current high levels of M&A activity in the space? The favorable industry environment obviously plays an important role, as does the fact that the industry is highly fragmented and offers numerous consolidation opportunities. However, we would argue that the most important factor driving higher levels of M&A activity is the presence of an increasing number of private equity-backed U.S. Telecom E&C companies. If we turn back the clock to the period prior to 2010, it was difficult to find well-capitalized buyers outside of the big, publicly-traded companies (Dycom, MasTec and Quanta Services). We now count more than 20 private equity-backed companies in the space. The typical playbook for private equity firms investing in a fragmented industry like Telecom E&C is growth through acquisition, and this is exactly what we are seeing. In the first part of the decade transactions involving financial backers represented only a small proportion of transaction volume, whereas over the past two years they accounted for the significant majority of deals.

Figure 5: Number of Financial and Strategic Transactions by Year



*Financial transactions include initial platform investments as well as acquisitions by financial-backed platform companies.

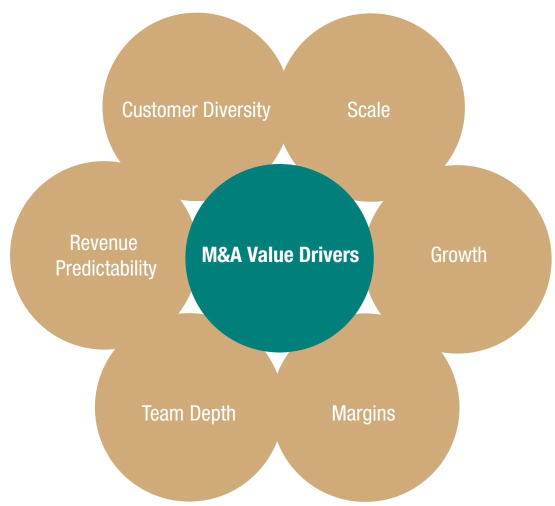
The presence of these private equity-backed companies significantly increases the chances that sellers can attract the interest of multiple strategic acquirers. Furthermore, the fact that so many of their peers have invested in the Telecom E&C space encourages new investors to search for platform investments of their own. In combination, these factors create a favorable M&A climate that leads to both higher valuations and a higher probability that transactions will be successful.

Valuation/Interest Drivers

Even with the favorable market dynamics, not all Telecom E&C companies are well positioned to attract acquirers and investors. In addition, valuation multiples can differ significantly from transaction to transaction. In our experience there are six main factors that impact a company's ability to attract interest from buyers and investors as well as its ultimate valuation. These factors can be summarized as follows:

- ***Revenue Predictability.*** The greater the degree of revenue predictability, the more valuable the company. In the Telecom E&C world, the gold standard is "turf" type agreements where one or two vendors have exclusive contracts to provide maintenance-related services in a defined geographic region. At the other end of the spectrum are large, project-based contracts that only run through a specific time period.
- ***Customer Diversity.*** Virtually all Telecom E&C companies have some degree of customer concentration, so it is rare to find companies with a truly diverse customer base. However, companies that have more than half of their revenue with a single customer tend to be viewed less favorably by the market. This is particularly true for private equity investors, many of whom will not consider these opportunities or (at best) value them at a steep discount.
- ***Scale.*** Larger companies generally attract more interest in the market and tend to trade at higher valuations. Company's typically need at least $3 million (and ideally closer to $5 million) in Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) to attract interest from private equity investors. Strategic acquirers may look at smaller deals, but it is challenging to overcome the objection that the transaction will not "move the needle" unless the seller can articulate a compelling strategic rationale such as an entrée into a new customer or a new service offering that can be leveraged across the acquirer's existing customer base.
- ***Growth.*** Acquirers are not paying for what a company is today, but for what it can become tomorrow. Company's that have a track record of growth and, ideally, a backlog of projects that support strong future growth tend to trade at premium multiples.
- ***Margins.*** Companies with high gross margins and EBITDA margins typically trade at higher multiples. This is because companies with higher margins are viewed as having more differentiation, and also because incremental revenues add more to the bottom line. A notable exception to this is that companies with low EBITDA margins will often trade at a low revenue multiple but at a relatively high EBITDA multiple. This is because these companies are typically underperformers, and acquirers believe they can increase EBITDA relatively quickly through cost cutting and other initiatives.
- ***Team Strength and Depth.*** Acquirers and investors like to see depth to the management team. In particular, they are wary of situations where all of the important customer relationships are concentrated with one or two individuals (especially when these individuals are also the owners). This dynamic creates significant risk for acquirers, particularly in situations where the owner are selling their entire stake in the company. Acquirers account for this risk through lower valuations and/or tying a significant portion of the purchase price to a long-term earn out as a way to incentivize key employees to stay with the business. Finally, while it is not as important to strategic acquirers, private equity investors like to see a team that includes strong support personnel in areas like operations and accounting.

Figure 6: M&A Value Drivers



Transaction Alternatives

Companies that elect to seek a transaction have two basic alternatives. The first is a sale to a strategic acquirer. A strategic sale has the advantage of providing owners with the greatest immediate payout. This is due to two factors. First, strategic acquirers almost invariably want to own all of the stock in whatever entities they acquire, so owners have no stake in the business post-transaction. Second, because strategic acquirers bring operational synergies to bear that can both increase revenues and decrease expenses, they tend to offer the highest valuations in M&A transactions. The disadvantage to a strategic sale is that the owners give up their entire equity position, so they lose the ability to benefit from future growth. While some strategic sales contain provisions for additional payments based on the future performance of the business, these amounts are generally small in relation to the total purchase price. This means that owners that sell to a strategic lose most of the potential upside in their business.

The second alternative is a sale to a financial buyer, most often a private equity firm. Financial buyers seek to acquire a significant portion of a business, typically somewhere between 40% and 80%. The remaining equity stays with the management team as an incentive for them to continue to grow the company. Financial buyer transactions provide owners with less liquidity at close, both because the owners are selling only a portion of the business and because prices from financial buyers are usually (but not always) a bit lower than what we see from strategic acquirers. On the other hand, the sellers still retain a significant equity stake in the business, so they continue to benefit from future value creation. Particularly when one considers that a typical private equity firm is looking to increase its investment threefold, sellers have an opportunity to take out just as much (and sometimes more) proceeds from a second transaction as they did from their initial sale.

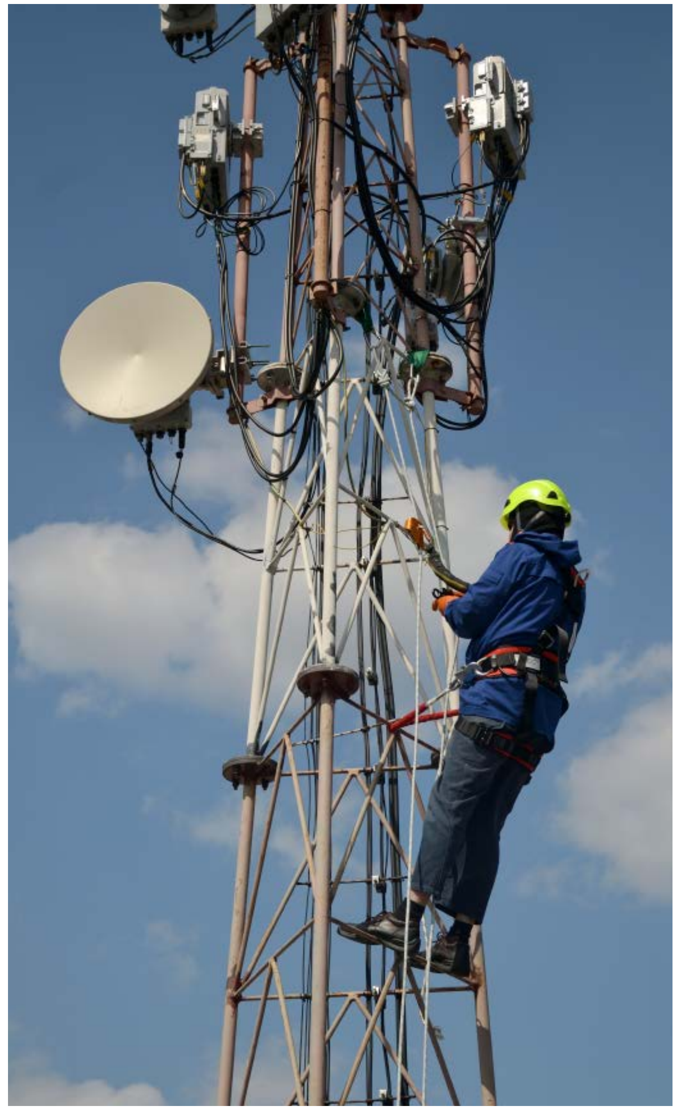
The right transaction type depends on a seller's situation. The first thing to look at is if the company has any red flags (typically a lack of scale, a lack of management depth and/or an extremely high degree of customer concentration) that will likely preclude interest from financial buyers. If any of these red flags are present, then a sale to a strategic acquirer may be the seller's only realistic option. If none of these obstacles are present, then the decision often boils down to whether or not the owners want to remain with the business for a three to five year period post-transaction. If they do, a transaction with a financial buyer may offer the most attractive option. In practice, we find that parties can pursue both opportunities simultaneously, and this is the approach that Focus typically recommends. By pursuing both alternatives, sellers can make an informed decision based on actual proposals as opposed to trying to guess which approach will yield the most attractive result.

Figure 7: Strategic vs. Financial Transactions

	Sale to a Strategic Acquirer	Sale to a Financial Buyer
Current Payout	• Sale of 100% of equity; maximizes current payout	• Sale of 40% to 80% of equity; lower current payout
Long-Term Upside	• No remaining equity stake in the business	• Substantial upside; owners retain a significant stake in the business
	• May have some upside in the form of performance-related bonuses or options	• Potential to take out just as much proceeds in a subsequent transaction as in the initial deal
Ongoing Owner Role	• Expect at least a 6-12 month transition period	• Owners typically remain in current positions
	• Could need longer to transition customer relationships	• Investors may bring in additional team m embers (such as a CFO)
	• Possible opportunity for a longer-term role	• Expect to remain with the business at least three to five years post-transaction

Should I Consider a Transaction?

The ideal time for an M&A transaction is when (i) the overall macro environment is good, (ii) the business is performing well and (iii) the sellers are motivated to seek a transaction. As we have discussed in this report, the M&A backdrop for the Telecom E&C space is highly favorable, so the first condition is certainly satisfied. For the second condition, while Telecom E&C businesses by their nature tend to experience a certain degree of lumpiness, acquirers and investors like to see a general trend of growth over the past three to five years. In addition, it is also important for companies that are considering a transaction to have a strong backlog going into a process. A typical process takes six to eight months to close, and the number one reason why processes fail is because sellers experience an unexpected dip in financial performance. The final condition is clearly subjective and largely comes down to the desires of the seller. For business owners that have a relatively near-term exit horizon (three years or less), if your company is performing well we believe the right advice is probably to take advantage of the current market environment and pursue a transaction. The Telecom E&C space has historically been cyclical, and companies that miss this current window may find themselves waiting five or more years before conditions are once again this favorable. On the other hand, owners that are comfortable waiting out another M&A cycle are in a much better position to delay a transaction, although even these may want to capitalize on the current market environment by selling a portion of their business to a financial buyer. Whatever the ultimate decision a business owner chooses to make, we believe that the backdrop for M&A transactions in the Telecom E&C space is the best it has been since the Telecom boom of the late 1990s, and business owners should give serious consideration to how they can best take advantage of the current window of opportunity.



Recent FOCUS Telecom Engineering and Construction Transactions

This announcement appears as a matter of record only

SDT

has been acquired by

UniTek GLOBAL SERVICES

The undersigned initiated this transaction, assisted in the negotiations, and acted as financial advisor to Southern Diversified Technologies, Inc.

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This announcement appears as a matter of record only

ADDvantage Technologies Group

has acquired

FULTON TECHNOLOGIES, INC.

The undersigned assisted in the negotiations, and acted as financial advisor to ADDvantage Technologies Group, Inc.

FOCUS Investment Banking

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Rich Pierce has nearly 20 years of investment banking experience advising middle market clients on a variety of mergers and acquisitions and capital raising transactions. During that time, Mr. Pierce's primary emphasis has been on serving clients in the telecommunications industry including network engineering and construction companies, providers of network related hardware and software products, wireless and wireline telecommunications service providers.

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David Freeland, a FOCUS Principal, has more than fifteen years of experience providing investment banking and management consulting services to a variety of corporate clients, ranging from the Fortune 500 to start-up businesses. He has been an investment banker since 2003, advising clients on mergers and acquisitions and capital raising transactions. Mr. Freeland has broad experience in the telecom and technology industry and has significant experience with data center companies.

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